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C O N F I D E N T I A L SECTION 01 OF 02 SANAA 000277

SIPDIS

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TAGS: EPET KCOR ECON YM ECON COM ENERGY
SUBJECT: DECLINING OIL AND PARLIAMENTARY INTERVENTION
EQUALS BAD TIMES FOR OIL BUSINESSES IN YEMEN

Classified By: DCM Nabeel Khoury for reasons 1.4 (b. and d.)

¶1. (C) Summary: Yemen's oil production is steadily declining, and may drop below 400,000 barrels per day (bpd) in 2005. (Note: Production reached a high of 490,000 bpd in 2003.) Mismanagement of existing oil fields accelerates production and could serve to reduce long-term yields. Current exploration is not expected to produce substantial gains. Hunt's Production Sharing Agreement (PSA) extension also may be jeopardized by corrupt side deals tacked on by ROYG negotiators that involve selling the ROYG's share of oil to other investors. In mid-February, Parliament is expected to review the extension and some MPs are threatening to cancel the deal. Declining oil prospects and increased activism against traditional, albeit corrupt, business practices are proving unsettling for major international oil companies, which could negatively impact future investment. End Summary.

Minister Acknowledges Diminishing Production

¶2. (C) In a statement to the London-based daily al-Hayat, Yemen's Oil Minister Rasheed Saleh Ba'raba announced on December 30 that oil production is expected to decline by 10 million barrels in 2005, leading to a negative impact on Yemen's to economic growth. (Note: The Economist Intelligence Unit (and confirmed by other sources) states that Yemen's oil production for 2004 is about 420,000 barrels per day. A ten million barrel drop would put production at about 390,000 bpd for 2005. End note). Yemen's 2004 GDP growth is estimated to be around 2 percent (from 3.5 percent in 2003), a decline due largely to reduced oil production. Ba'raba pointed to a possible contract with French Company Zinco Ox to open a Zinc and Lead mine as an alternative source of revenue. According to Henry Thompson, a British environmental scientist and Yemen expert, mineral extraction in Yemen is still too costly and companies interested in Zinc (mostly Canadian firms) were not yet comfortable investing in Yemen.

¶3. (C) Yemen Hunt GM Wyndell Caviness, told Pol/Econ Deputy that Hunt's production was down ten percent in 2004 and Canadian Nexen's production dropped 40 percent the same year. Caviness predicted that total ROYG production may fall below 400,000 bpd next year. Nexen's new PSA (near its existing Masila Block) is only producing 4-5000 barrels per day, Caviness said, and production may never rise above 20,000 bpd. (Note: Some ROYG oil officials have touted the new Nexen field as the next great find in Yemen and maintain that the second field alone will be able to compensate for diminishing returns in older fields. End note). He observed that the relatively low production levels of the new Nexen block are indicative of future oil discoveries in Yemen. According to press reports as well as a World Bank study released in March, Nexen's Masila block produced a higher water to oil ratio than expected in 2004, accounting for the rapid production decline. The report adds that without new discoveries are found, Yemen could deplete its resources by ¶2012. (Comment: While it is unlikely that there will not be any new oil finds, the study makes clear Yemen's near-term problems with oil depletion. End comment.)

Existing Resources Mismanaged

¶4. (C) Estimates on Yemen's proven reserves range from 1.3 billion barrels (World Bank) to 4.0 billion (Ministry of Oil) barrels in 2004. Thompson believes that Yemen's Ministry of Oil and regulatory agencies do not manage their existing oil resources for sustainable production. The Ministry of Oil, Thompson asserted, takes undue time and charges oil companies unnecessarily for activities such as drilling new wells in production blocks. The Ministry's time-consuming, overly bureaucratic processes are a disincentive for oil companies to drill new wells and encourage companies to pump oil with as few wells as possible. Thompson explained that fewer wells were inefficient and poor management can cause as much as 20 percent of the oil in a field to be left behind. (Note: Several foreign oil company executives echo similar complaints regarding the Ministry of Oil. End note). Senior Oil Ministry officials also directly ask Oil companies to maintain high yields also contributing to declines in production. Thompson concluded, "when it goes, it will go

fast."

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Parliament Scrutinizing Oil Deals -- Hunt's Next
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¶5. (C) New allegations surrounding government corruption in the oil sector may harm Hunt's bid to extend its PSA for Block 14 beyond the October 31 expiration date. Hunt suffered through tense negotiations with the ROYG for three years before reaching a Cabinet deal in 2004 to extend its operations from 2005-2010. Caviness admits that in order to continue operating in Yemen, Hunt was forced to give up half of its share of oil. Allegations have emerged (and are likely true) that the ROYG sold its additional share of the oil from Block 14 to Crest Oil -- the same company involved in the now infamous Block 53 scandal uncovered by Parliament in 2004. According to Parliament watcher, Saad Talib, the sale's loss to the treasury could be as much as 5 billion USD and predicted that "Parliament would not ratify the extension." Caviness, however, is optimistic and hinted at serious, high-level lobbying on behalf of Hunt.

¶6. (C) Hunt is presently in negotiation with the Petroleum Exploration Production Agency for an additional PSA in an undisclosed area. Describing the block as "something a major oil company would be interested in," Caviness expressed frustration with the ROYG for delaying the extension and over difficulties in the current PSA negotiations. Caviness also confided that until their PSA extension with Parliament is resolved, Hunt was reluctant to move forward on the new PSA.

Comment

¶7. (C) Comment: While Parliament has threatened to break the Hunt extension, Post believes a deal will be worked likely voiding the government's questionable sale of its oil share and allowing the largest American company in Yemen to continue operations. That said, if Hunt is forced to cease production in 2005, the largest American investment in Yemen would disappear, leaving it its wake dim prospects for other large potential U.S. investments.

¶8. (C) Comment continued: With Yemen's near-total reliance on oil for government revenue and economic growth, oil production declines will have a negative impact on its ability to expand development spending. High-oil prices offset the 2004 declines, but this may not hold true in 2005. Some oil watchers are hopeful that production levels may climb back up to the 450,000 bpd mark. However, with Yemen's population rising at 3.9 percent, unemployment at 35 percent (conservatively) and limited alternate sources of revenue, the oil decline is likely the biggest economic challenge Yemen will face in the next five years. End comment.

Krajeski